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OUTLOOK

August 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The economic expansion continued through the second quarter of 1988, as the annual growth rate of real GNP reached 3.1 percent, according to the U.S. Department of Commerce. The second quarter pace was just below the revised first quarter annual rate of 3.4 percent.
- The American economy is enduring a fundamental change in the source of GNP growth, which is coming to rely less on growth in consumer spending and more on growth in export demand and business spending on fixed investment.
- Inflation indicators are throwing out some conflicting signals, but the prospects are good for moderate price advances through 1988. The annual rate of consumer price inflation is expected to remain near 5.0 percent through 1989.
- In an effort to keep inflation under control, the Federal Reserve Board has recently adopted a tighter monetary policy stance by nudging up short-term interest rates. This upward trend in short-term rates has already led to slowly rising long-term interest rates. Rates on 30-year fixed rate mortgages will likely inch above 11 percent by yearend before stabilizing near 11.5 percent in 1989.
- High rates of employment and slowly rising mortgage rates have contributed to the fifth consecutive monthly advance in the annual rate of existing home sales. In June, sales of existing single-family homes reached an annual rate of 3.78 million units, a gain of 5.3 percent over the May annual rate of 3.59 million units and 5.6 percent faster than the sales pace of June 1987.

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DEWKS, DENKS, and the Magnificent Millenium

Economic Commentary

by
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Callin' out around the world
Are you ready for a brand new beat?
--Martha Reeves

In *The Proud Tower,* Barbara Tuchman describes that last glorious summer of western civilization, the period just before World War I. Not since has such an all-pervading sense of optimism been present. On the contrary, in comparison with what has followed, the horrors of the Great War -- which forever shattered that spirit -- seem almost quaint. Depression, war, conflict and tensions have enshrined pessimism as the dominant world view. But now, in the last summer of the age of Reagan, there are some straws in the wind that suggest yet another turn, and a return of hope for a brighter world in the coming millenium.

The political straws are obvious, summarized by perestroika in the Soviet Union and the realization by Iran that dying for Allah works as a foreign policy only until you exhaust the supply of those willing to do so. But let's look at the domestic economy, where there is accumulating evidence that we are poised for expansion through the remainder of the century. Despite the drought, the falling dollar and capacity strains in some industries, inflation has remained modest, and is likely to continue so. The pressures in the labor market that we feared seem not to have materialized. In an earlier day, increased demand for output would have invariably led to union pressures and higher wages. Now, that increase results in slower delivery of output and more modest (if any) wage increases. Translation: the auto workers are still getting the same wage, but on a Saturday noon, it'll take you three minutes longer to get your burger because the fast-food proprietor can't get enough staff despite paying an extra $.15 an hour.

And, while labor pressures -- especially among low-skill jobs -- may well increase, the economy has undergone a transformation that may well keep those pressures from short-circuiting economic growth. The Census Bureau reports that since 1976, married households with both spouses employed and with children (termed by the *Wall Street Journal*, "DEWKs" -- double employment with kids) have increased by 61 percent, and those without children ("DENKs" -- double employment, no kids) are up 31 percent. Moreover, two-thirds of all college-educated married women with children under the age of one are employed outside the home. Now, it has been argued that these figures point up the need for two incomes just to survive. I think, rather, that they suggest the real dimensions of the social revolution that has occurred over the past twenty years. Gainful employment is a proud profession, and labor force participation is up. This will yield a high productivity labor force that will bias the economy toward growth through the remainder of the century.

Bolstering the changes that have taken place in the labor force, is the seeming accommodation this economy has made to the internationalization of goods and securities markets. While the dollar has dropped since 1985, recent movements have been of a fine-tuning nature, and the trade deficit has responded by settling into a "soft landing" glide toward zero. This is stabilizing and reviving those manufacturing industries that have never really recovered from the double blows of high inflation and a surging dollar in the early Eighties. Moreover, the free flow of capital across borders seems to have locked domestic interest rates into a moderate band. Again, stability that should promote growth.

These are only straws in the wind, and much can happen to reverse the current pattern. We still spend more than we earn, and the next president *must* come to grips with Federal deficits quickly. Done wrong, that can scuttle prosperity by as early as the end of next year. But for now, everything is moving in the right direction. Interest rates and inflation remain moderate, unemployment is down and growth continues strongly. More importantly, all this is no fluke -- the fundamental forces that will shape this economy through the remainder of the century are all pointing to continued expansion. If we can smoothly correct the problems posed by the Federal deficit and a low savings rate, then we will end this millenium on a high note. As the song says,

Summer's here and the time is right
For dancin' in the street.

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

Real GNP growth advanced at an annual rate of 3.1 percent in the second quarter, only marginally slower than the first quarter's revised rate of 3.4 percent, according to the latest estimates by the U.S. Department of Commerce. The new data shows that economic growth is becoming more evenly balanced across several sectors of the economy, rather than relying solely on consumer spending. But, in the unending search to make bad news out of good, some analysts suggested the GNP report could touch off an acceleration of the inflation rate. For evidence, they cited the 4.1 percent rate of advance in the GNP deflator (considered to be a broader measure of inflation than the oft-cited CPI) which was much stronger than the 1.7 percent annual rate reported for the first quarter, and the fastest advance since the first quarter of 1984. However, government economists stated that drought-related food price increases were largely responsible for the faster second quarter inflation rate, and that an accelerating rate of price increases was not imminent.

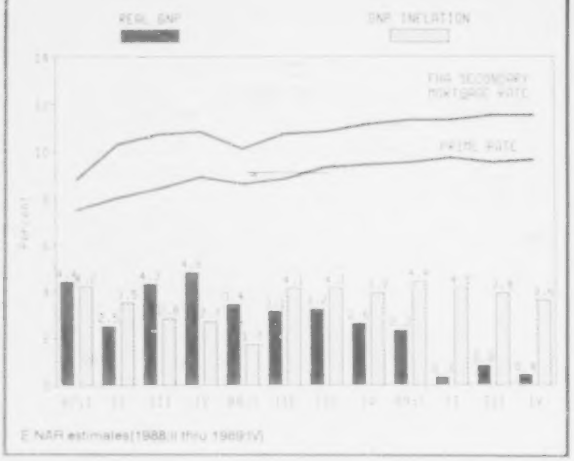
From Consumption to Exports and Investment

The composition of real GNP growth outlined in the second quarter report likely enhances the chances of continued moderate rates of inflation. The reason: a shift in domestic spending away from consumption and into business investment. As seen in Graph 2, the rate of growth in consumer spending slowed to about half the pace of the first quarter. The rate of business spending for equipment was down slightly from the first quarter rate, but was again a large contributor to GNP growth. The purpose for the intensive investments in equipment spending is to allow U.S. firms to meet the demand for U.S. exports. Growth in net exports (exports minus imports) was the largest single contributor to real GNP growth in the second quarter. All of these statistics add up to one central theme: the U.S. economy is managing to make the delicate transition from a consumer-led expansion to one powered by demand for U.S. exports. Such a fundamental change in the source of economic growth has been sought after for some time, and now appears to have arrived.

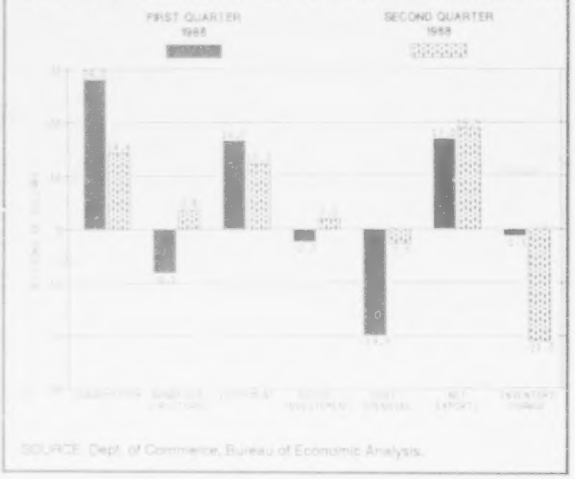
Profile of a Sea Change

This broad change in the composition of U.S. economic growth (or "sea change" as some call it) has been gaining momentum behind the scenes ever since the dollar began to decline in value during February of 1985. But for reasons ranging from time lags between exchange rate changes and trade flows (often called the J-curve), to substantial profit margins on imports that kept U.S. dollar prices from rising, the improvement in trade has been a long time in coming. As recently as the first quarter of 1987, spending on fixed investments by U.S. businesses had been dropping. Meanwhile, export growth began rising steadily in the third quarter of 1986, and then explosively from the second quarter of 1987. While capacity constraints are being reached in many industries, U.S. firms have embarked on a major re-tooling effort to meet the increased export demand. Fortunately, domestic consumption has remained modest.

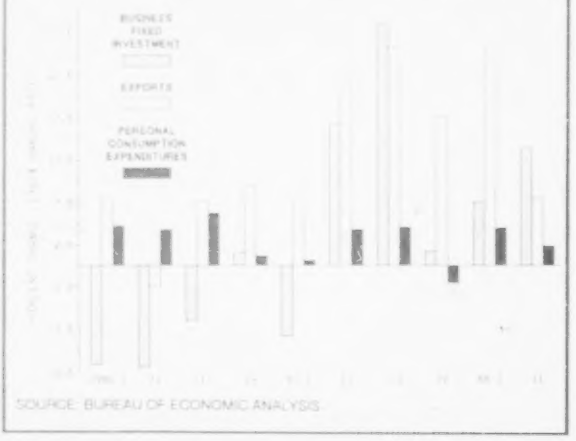
GRAPH 1: THE ECONOMIC OUTLOOK



GRAPH 2: THE COMPOSITION OF GNP GROWTH



GRAPH 3: CONSUMPTION REMAINS MODEST AS EXPORT AND INVESTMENT GROWTH SURGES



Where Have All the Consumers Gone?

As the previous graph shows, growth in consumption has been lagging the rate of advance of exports and business fixed investment. But actually, in the course of the present sea change in economic growth, fast growth rates in consumption are not desirable. A resurgence of consumer spending at a time when business investment and export growth are surging could overheat the economy and produce a recession. What is the likelihood of another growth surge in consumer spending? Probably pretty slim, what with consumer installment debt as a percent of personal income nearing 16 percent. In fact, for the past few years it has been fashionable to say that the consumer has spent himself into an oblivion of installment debt. The only way out is for the consumer to buy down this debt, rather than rack up new purchases. Recent data on personal saving suggest the consumer may have begun to do so. If so, a prolonged period of modest growth in consumption and an increasing savings rate could contribute to economic growth that is more balanced across all sectors.

Inflation Stays Moderate

The second quarter GNP report was in almost every respect a perfect report -- demand was not overheating, and it was distributed across several sectors. The report's one imperfection was that the GNP deflator indicated a faster rate of overall inflation than had been expected. The deflator rose from an annual rate of 1.7 percent in the first quarter to 4.1 percent in the second quarter. As said earlier, the drought was partly to blame for the deflator's advance. But other potential sources of inflation remain. Prices of imported goods, for example, have continued to rise as the lower dollar has forced many foreign producers to raise the dollar prices of their goods exported to the U.S. Wages in the manufacturing sector, still being held under control, could be the next source of inflation if domestic production to meet export demand is not accommodated by sufficient gains in capacity. The more commonly quoted measure of inflation, the consumer price index (CPI), shows the rate of inflation in the first half of 1988 was no faster than it was during the same period in 1987. The current forecast estimates consumer price increases will register in the 4.5 to 5.0 percent range during the remainder of 1988 and into 1989.

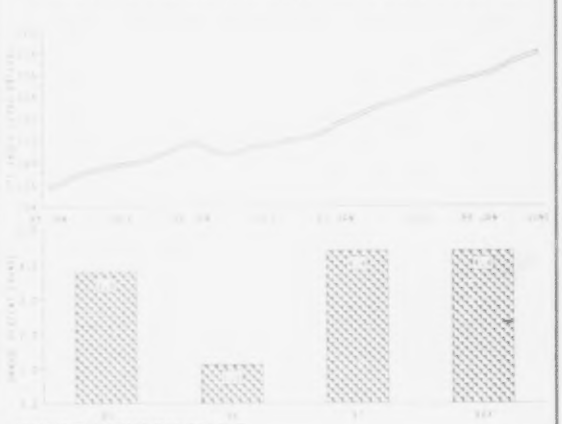
Monetary Policy and Interest Rates

In his midyear report to Congress, Federal Reserve Board Chairman Alan Greenspan reconfirmed his commitment to control inflation. Mr. Greenspan indicated the Fed stands ready to nudge interest rates higher to slow economic growth in 1988 to forestall any acceleration in the rate of inflation. He suggested a GNP growth target of 2.7 to 3.0 percent was in line with the economy's "long run potential," but lower than the 3.3 percent GNP growth rate of the first half of 1988. Indications are that the Fed has already tightened credit considerably. Graph 6 illustrates the effects of this recent tightening, where rising short-term interest rates have caused a gradual flattening of the yield curve.

GRAPH 4: HIGH CONSUMER INDEBTEDNESS PROMISES MODERATE CONSUMER SPENDING

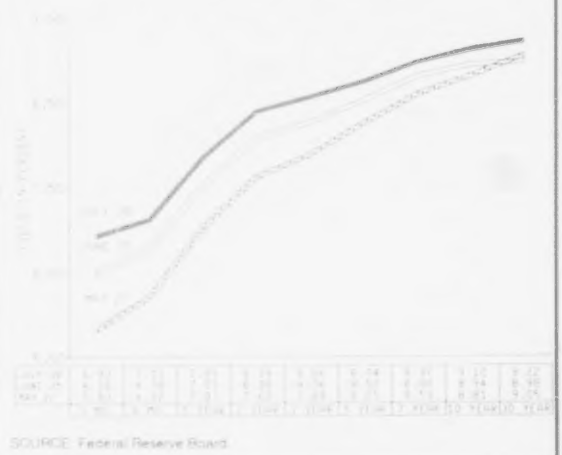
SOURCE: Bureau of Economic Analysis

GRAPH 5: INFLATION REMAINS UNDER CONTROL



*SIX MOUNTH AVERAGE ENDING IN JUNE
SOURCE: Bureau of Labor Statistics

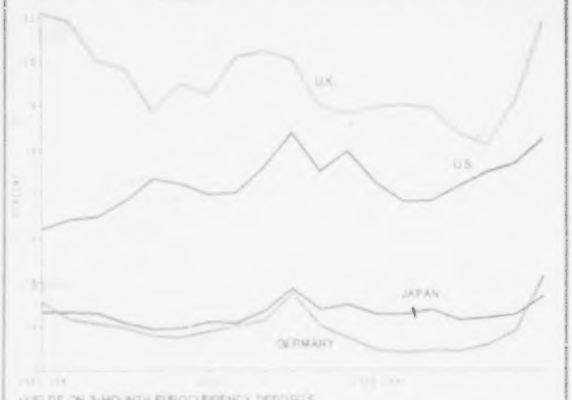
GRAPH 6: THE YIELD CURVE



SOURCE: Federal Reserve Board

The Federal Reserve has not, however, been alone in its move towards a tighter credit policy. In fact, the Fed has been joined by all the central banks of Western Europe and Japan. Much of this has been in keeping with a concerted effort by the foreign central banks to halt the recent rise of the dollar; which rose 8% against the mark and 7% against the yen between June 14th and July 15th. But, extremely large short-term interest rate hikes in both Germany and Britain have been influenced by domestic concerns as well. In Germany, the Bundesbank has increased rates substantially in an attempt to slow the outward flow of capital. The British central bank has actually pushed short-term rates higher than the long-term government bond yields in the hope of slowing domestic consumption in order to eventually shrink the British trade deficit. Regardless of the reasons, short-term credit has become more dear around the globe, narrowing the gap between short-term and long-term rates, and contributing to a general flattening out of yield curves internationally.

GRAPH 7: SHORT-TERM RATES ARE RISING

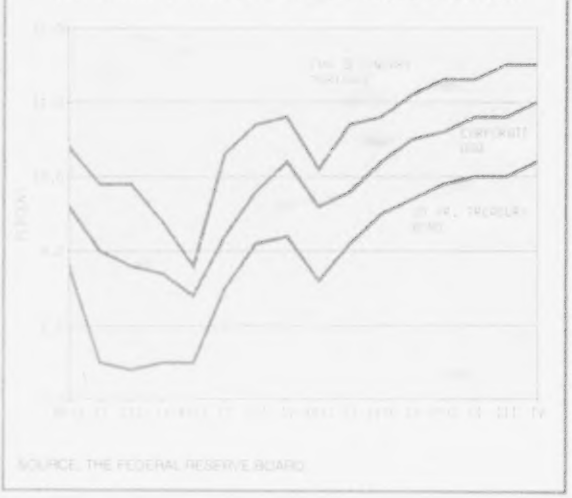


*YIELDS ON 3-MONTH EUROCURRENCY DEPOSITS

SOURCE: International Monetary Fund and The Economist

In reacting to rising rates of inflation by increasing short-term interest rates, the Fed has, to some extent, validated the inflationary concerns of the financial markets. In turn, longer-term interest rates, which are very sensitive to changes in expectations regarding inflation, have increased as well. While the anti-inflationary actions by the Fed and an encouraging consumer price index may have taken some of the pressure off the trend toward higher long-term rates, the mixed blessing of an overheating economy helps keep the pressure on. Thus, mortgage rates could continue to rise through the rest of this year to 11.1 percent in the fourth quarter, before leveling off in 1989 at about 11.4 percent.

GRAPH 8: LONG-TERM INTEREST RATES



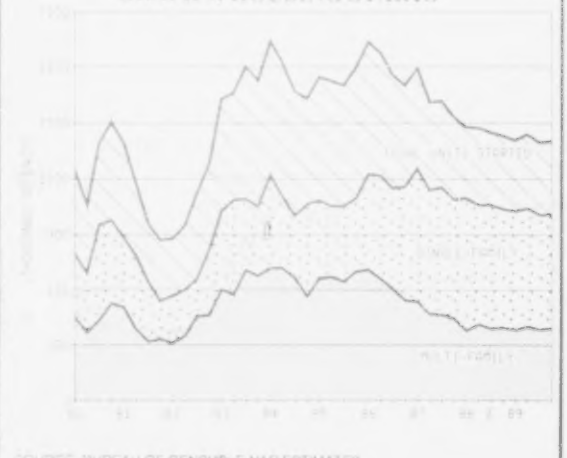
SOURCE: THE FEDERAL RESERVE BOARD

REAL ESTATE MARKETS

Housing Starts

Starts of privately owned housing units reached a seasonally adjusted annual rate of 1.454 million units in June, 5 percent above the May annual rate of 1.384 million units. The June 1988 annual rate was 8.1 percent slower than the June 1987 annual rate of 1.583 million units. Single-family units were started at an annual rate of 1.098 million units, 10 percent faster than the May annual rate of 996 thousand units. However, a decline in the annual rate for starts of multi-family units offset part of the advance in the pace of single-family starts. Specifically, multi-family starts with five or more units fell from an annual rate of 327 thousand units in May, to an annual rate of 296 thousand units in June. Starts of multi-family units with 2-4 units reached an annual rate of 60 thousand units, virtually unchanged from the May annual rate of 61 thousand units. Putting aside annual rates, during the first six months of this year, 738,900 housing units were started, an 11 percent decline from the 829,200 units total for the same period in 1987. However, the continuation of very high rates of employment and slowly rising interest rates should help keep housing starts near a level of 1.4 million units through the end of 1988.

GRAPH 9: HOUSING STARTS



SOURCE: BUREAU OF CENSUS & NAR ESTIMATES

New Home Sales

Sales of new single-family homes surged to their fastest annual rate of the year, reaching a seasonally adjusted annual rate of 734 thousand units in June. This marked an 8.4 percent gain over the May annual rate of 677 thousand units. With the exception of a slight pause in May, the annual rate of new single-family home sales has increased in every month since December 1987. But the national number for June new home sales covers up large differences in the pace of home sales among the different regions of the country. In the Northeast, new home sales surged 15.5 percent to reach an annual rate of 119 thousand units, while in the West new home sales advanced 28.9 percent to an annual rate of 245 thousand units. Alternatively, new home sales in the South crept up only 4.2 percent to an annual rate of 273 thousand units, while in the Midwest new home sales showed little change at an annual rate of 97 thousand units. During the first half of the year, a total of 364 thousand transactions were recorded, down 3.5 percent from the same period in 1987. During the remainder of 1988, the annual rate of new home sales is expected to average 630 thousand units.

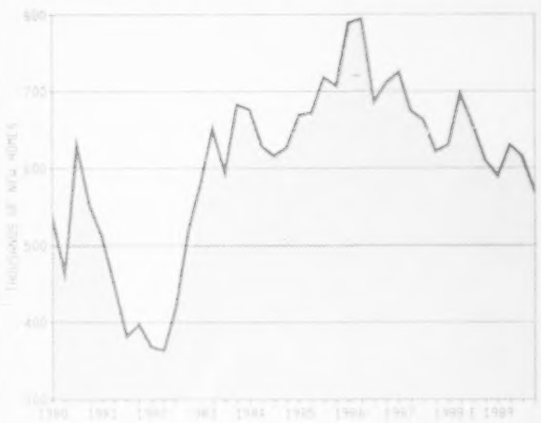
Existing Home Sales

In June, sales of existing single-family homes reached an annual rate of 3.78 million units, a gain of 5.3 percent over the May annual rate of 3.59 million units. This marked the fifth consecutive monthly advance in the annual rate of existing home sales. Furthermore, for the first time in 12 months, existing home sales were sold at a faster pace than the year earlier period. The June 1988 annual rate was 5.6 percent faster than the June 1987 sales pace of 3.58 million units. By region: June sales of existing single-family homes reached 700 thousand units in the Northeast (down 2.8 percent from 720 thousand); sales in the Midwest reached 1.0 million units (up 8.7 percent from 920 thousand); sales in the South reached 1.43 million units (up 9.2 percent from 1.31 million); and sales in the West reached 690 thousand units (up 7.8 percent from 640 thousand). Sales volume in all regions equalled or surpassed the June 1987 pace. Putting annual rates aside once more, existing home sales totaled 1.756 million units during the first six months of this year, 3.6 percent below the 1.822 million homes total of the first half of 1987. The second half of this year will still exhibit considerable strength in existing home sales. With economic growth expected to continue due to export growth and business fixed investment, the expected modest rise in interest rates will likely encourage many potential homebuyers to purchase homes earlier than they had planned.

Home Prices Continue to Advance Strongly

The median price of an existing single-family home rose to a new high of $90,600 in June, 2 percent above the May median price of $88,800 and 5.5 percent higher than the June 1987 median price of $85,900. The June median price for new single-family homes reached $117,800, a 7.1 percent gain over the May median price of $110,000 and 8.1 percent higher than the June 1987 median price of $109,000. Faster rates of inflation in the coming months and continued strong housing demand will likely keep home prices advancing faster than the rate of inflation.

GRAPH 10: NEW HOME SALES

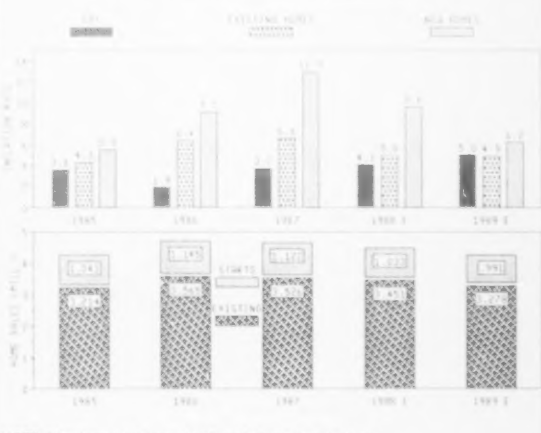


SOURCE: BUREAU OF CENSUS; E NAR ESTIMATES

GRAPH 11: EXISTING SINGLE-FAMILY HOME SALES
(SEASONALLY ADJUSTED ANNUAL RATES)

SOURCE: NAR ECONOMICS AND RESEARCH; E NAR FORECASTING & POLICY

GRAPH 12: HOME PRICES



NOTE: New home total equals 97% of single family starts.

Obstacles to Becoming a First-Time Homebuyer: A Look at NAR Survey Data

Introduction

Since its 1980 peak of 65.6 percent, the homeownership rate has fallen to 64.0 percent in 1987. The decline for younger households has been much more acute: a decline of 7.4 percentage points for 25 to 29 year olds (43.3 to 35.9 percent) and a decline of 7.9 percentage points for 30 to 34 year olds (61.1 to 53.2 percent). [See Chart 1]. These age groups have historically encompassed the bulk of first-time homebuyers.

The falling homeownership rate for younger households has been attributed to reduced housing affordability--higher real house prices, higher user cost of housing, lagging incomes, etc. It seems reasonable to connect one with the other, but it is instructive to analyze the attitudes and housing decisions of younger households directly to make the connection explicit. That is, are younger renters foregoing (or delaying) homeownership because they want to or because they must?

A special NAR survey of households allows us to compare the characteristics and attitudes of younger first-time homebuyers--those that have overcome the barriers to entering homeownership--with those who are yet renters (i.e., who have never owned). The evidence strongly shows that most younger renters (who have never owned) remain renters due to the financial burdens of attaining ownership.

Still Part of the "American Dream?"

Based on the results of several nationwide polls, homeownership still constitutes a primary component of the "American Dream." In a 1988 poll for the National Housing Institute, two-thirds of those under the age of 35 who do not own a home consider buying a home an important goal, and 17 percent regard it as their most important personal goal.

Similar attitudes appear in the NAR homeownership survey. To assess the future directions and prospects for homeownership, NAR conducted a nationwide survey in late 1986.[1] Over three thousand (3,254) households responded, 83 percent indicating that owning a home was indeed part of the "good life." But of those 83 percent, over one-quarter of the households had never owned a home.

CHART 1: HOMEOWNERSHIP RATE

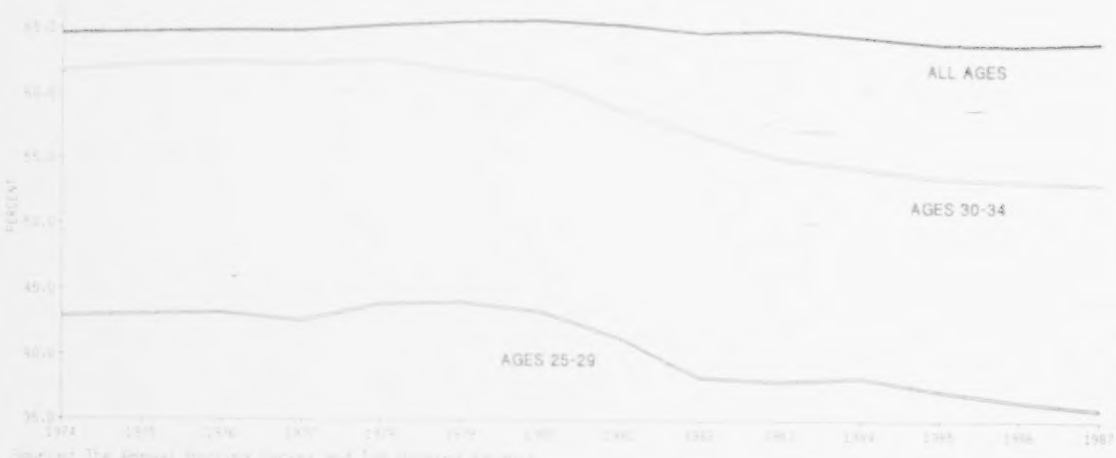
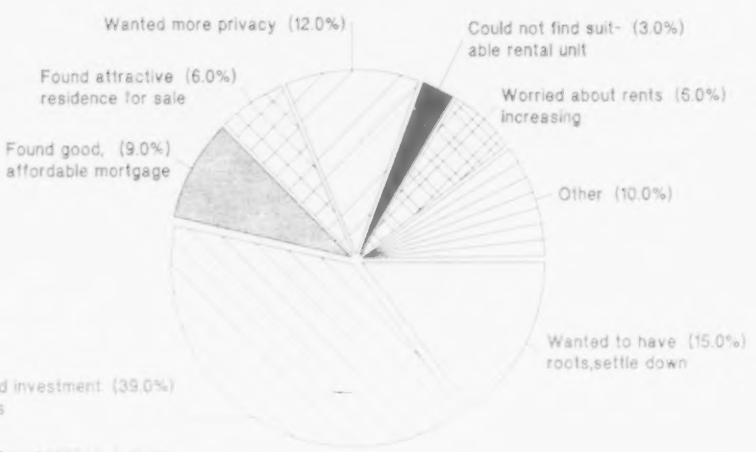


CHART 2: THE HOME PURCHASE DECISION

Primary Reasons Given By First-time Homebuyers Under Age 40


Wanted more privacy (12.0%)
Could not find suitable rental unit (3.0%)
Found attractive residence for sale (6.0%)
Worried about rents increasing (6.0%)
Found good, affordable mortgage (9.0%)
Other (10.0%)
Wanted to have roots,settle down (15.0%)
Tax and investment reasons (39.0%)

Source: 1986 NAR Homebuyer Survey

The reasons that first-time homebuyers under age 40 give for buying their homes offer clues into the desirable features of homeownership. [See Chart 2]. To many, homeownership is associated with stability, with 15 percent of young first-time homebuyers indicating that their primary reason for buying is to settle down and establish roots. Additionally, 39 percent indicated tax or investment benefits, and twelve percent noted the demand for privacy as their primary reasons for wanting to attain homeownership.

Many renters will seek single-family detached housing (and homeownership) when they begin planning a family. About two-thirds of owners and one-half of renters in the NAR survey "agree a lot" (and another 20 percent "agree") that it is important to have a yard for private use. Households agree even stronger that a private yard is important if children are present; about 70 percent of both owners and renters "agree a lot", and over 90 percent at least "agree." Thus, the evidence indicates that homeownership satisfies important personal and investment needs.

The First-Time Homebuyer - Obstacles to Homeownership

In the past few years, the road to homeownership for the first-time homebuyer has never been rockier. The financial obstacles to attaining homeownership have become more severe.

- **Real Housing Prices Have Risen.** Real house prices (new constant-quality home) surged 27.5 percent between 1971 and 1979. Whereas real house prices actually declined 4.9 percent between 1979 and 1985, they remain high by historical standards.
- **Homeownership Costs Have Risen.** The after-tax cash cost of homeownership (mortgage interest, utilities, maintenance and repair, insurance, and property taxes, less income tax savings) is currently well above its level during the 1960s and early 1970s. The slowdown in house price appreciation in recent years (in most areas) has diminished the investment motivation for homeownership.
- **Real Interest Rates Are Higher Now.** The high market interest rates of the early 1980s have declined, but inflation has fallen by more, so real borrowing cost (i.e., the market interest rate less inflation) remains high by historical standards. While the availability of adjustable rate mortgages has helped many households obtain lower initial rates, real rates nevertheless remain high.
- **Affordability Has Worsened.** Increases in household income have lagged increases in home prices, making house payments less manageable for the bulk of the population. In 1986, the ratio of the median price of a single-family house to the median household money income was 2.75. This is well above the ratios of the early 1970s, which were typically between 2.30 and 2.40.
- **Up-front Costs Are More Difficult To Meet.** The required downpayment has skyrocketed with the prices of homes. With savings squeezed by rising prices, especially rents (real contract rents rising 16 percent in 1987 from their low in 1981), the accumulation of a downpayment through household savings has become increasingly difficult. Furthermore, the closing costs require an additional several thousand dollars up-front.
- **Transactions Costs Are High.** Many younger households are quite mobile, e.g., expecting moves for employment and other reasons. Thus, it can be costly for them to buy and then relocate shortly thereafter.

Attaining Homeownership

Who are the households that are overcoming these obstacles to homeownership? Where are they getting their downpayment? Do these first-time homebuyers differ substantially from the remaining renters? The results of the NAR survey can help answer these questions.

From the NAR survey data, it is possible to distinguish between those renters who have never owned and current renters who have owned before. The latter group are likely those who are only temporarily renting, e.g., due to a job transfer. The former group we can term "potential" first-time homebuyers. Thus, we compare the characteristics of first-time buyers to those renters who have never owned. For the purposes of this analysis, a "first-time homebuyer" is a household that bought their current home (their first home) in 1984, 1985 or 1986 (survey taken in November 1986). Moreover, we confine the following analysis to households below 40 years old (which includes most of the first-time homebuyers) in order to control for differences in income, etc., that are due strictly to age.

Not surprisingly, first-time homebuyers have greater incomes than those who have never owned, but less income than other, more "seasoned" owners (below 40). The median income (in 1984) of first-time homebuyers is $23,200, while for other owners it is $25,900 and for renters (who have never owned) it is only $15,300. Of these "potential" first-time owners, 31 percent have incomes below $10,000, while only eight percent of the first-time buyers do. Most of these low-income renters, then, are far from being "potential" first-time buyers.

Marital status also differs among these groups. Fifty-eight percent of the first-time buyers are married couples, nearly as high as other owners (64 percent). Only 34 percent of the remaining renters are married couples. Thus, renters with sufficient incomes who have a more "stable" household pattern, i.e., married couple, are more apt to become owners.

Renters who are close to being first-time buyers are those who have never owned and who "seriously considered" owning at their last move. Even for these renters, insufficient financial resources dominate as reasons for not becoming owners. Nearly 90 percent of these renters cited that their inability to obtain the necessary downpayment was one of their reasons for renting; and 44 percent gave this as their *primary* reason for renting. One-third also noted insufficient money for closing costs as one reason for renting. Moreover, over one-third of these renter households said that high mortgage rates were a reason for choosing to rent, and nearly one-half cited high house prices. Chart 3 shows the distribution of these renting households by their *primary* reason for choosing to rent.

The Downpayment and Household Savings

The NAR survey shows that the overwhelming majority of households below 30 years of age save little in financial assets. That is, 72 percent of these younger households save less than five percent of their income in financial assets, and 45 percent save less than one percent.

When they do eventually accumulate a sufficient amount of savings, many of them purchase a home and convert this liquid wealth into relatively illiquid home equity. The average downpayment of first-time homebuyers (under 40) in the NAR Survey is $8600. Of that, an average of $5500, or 64 percent, comes from savings. Loans constitute an average $1200, or 14 percent. An average of only $800, or 9 percent, comes from gifts (from relatives). Obviously, repeat homebuyers can--and do--rely on accumulated home equity for most of their downpayments. [See Table 1].

Conclusion

The evidence suggests that most households desire homeownership and would like to attain it. While very low-income households will have severe difficulties in overcoming the financial barriers to attaining homeownership, it is within reach for many others. The main obstacles that renter households (who have the incomes and other characteristics that truly make them "potential first-time homebuyers") face is the accumulation of the downpayment and closing costs. Consequently, business or government programs and policies geared to assisting renters in overcoming this obstacle may be quite fruitful for making homeownersip attainable.

[1]The survey contained questions about: 1) the condition of the household's current and prior dwelling units and neighborhoods; 2) the household's expected future mobility; 3) the impact of tax changes on the decision to purchase; 4) the cost of housing and method of financing (for owners); 5) household savings, including percent of income saved, and source and intent of savings; 6) the household's involvement in political, community and church activities; and 7) the household's attitudes about homeownership and citizenship.

by
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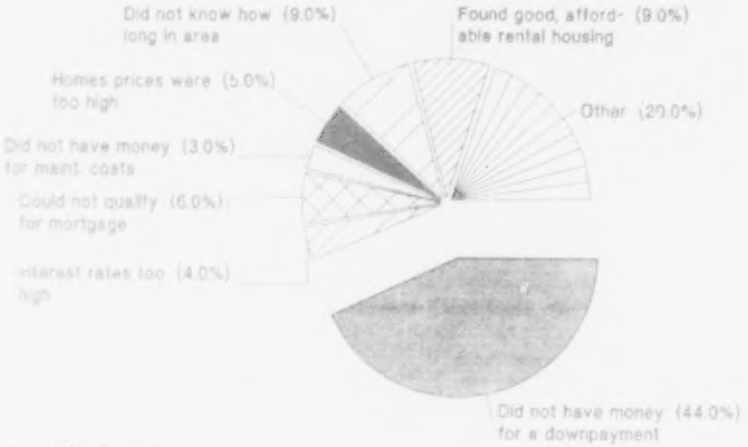
CHART 3: WHY RENT?

Primary Reasons Given By Prospective First-time Homebuyers


Did not know how long in area (9.0%)
Found good, affordable rental housing (9.0%)
Homes prices were too high (5.0%)
Other (20.0%)
Did not have money for maint. costs (3.0%)
Could not qualify for mortgage (6.0%)
Interest rates too high (4.0%)
Did not have money for a downpayment (44.0%)

Source: 1986 NAR Homeownership Survey

Table 1

SOURCE OF DOWNPAYMENT

	First-Time Homebuyers		Repeat Homebuyers	
	Avg. $ amount from:	% of Total Downpayment	Avg. $ amount from:	% of Total Downpayment
Savings	$5,553	64%	$4,369	25%
Equity from previous home	0	-	10,573	61
Refinance of investment property	0	-	216	1
Gift from relatives	797	9	339	2
Loan from relatives	1,229	14	547	3
Life insurance	26	-	227	1
Other	1,051	12	1006	6
Total	8,656	100%*	17,277	100%*

*May not add to exactly 100% due to rounding

SIGNIFICANT REAL ESTATE-RELATED TECHNICAL CORRECTIONS

Technical Corrections Update

On July 14, 1988 the House Ways and Means Committee reported the Technical Corrections Act (TCA) to the full House. The House is expected to begin debate of the bill August 4th, where approval is likely.

The Senate Finance Committee, chaired by Lloyd Bentsen, began and completed its markup of the bill on July 26. In light of the selection of Senator Bentsen as the Democratic Vice Presidential candidate, the bill reported out of the committee is "clean". It does not contain as many of the revenue raising amendments nor any of the extensions of expiring provisions the House bill contains. It is possible that these provisions will be added to the bill on the Senate floor either separately or as a package. Differences between the House and Senate versions of TCA will need to be reconciled in conference before both Houses recess for the fall elections.

The Mortgage Revenue Bond and Mortgage Credit Certificate Programs

The House version of the bill extends the Mortgage Revenue Bond (MRB) and Mortgage Credit Certificate (MCC) programs until the end of 1990 and made the following modification to those programs.

- An income limitation of 115 percent of area median income would apply to families of three or more. For other households, the income limitation would be 100 percent of area median income.
- Special adjustments to the income limitations for nontargeted areas would apply in areas having significantly high or low ratios of housing costs to area incomes when compared to national norms.
- Issuers of qualified mortgage bonds and qualified veterans' mortgage bonds would be required to rebate arbitrage profits to the Federal Government under the rules that now apply to issuers of other private activity bonds.
- A three-year loan-origination period would be imposed for qualified mortgage bonds. Unspent proceeds and prepayments must be used to redeem bonds.
- An amount equal to the special subsidy provided by qualified mortgage bond-financing or an MCC (but not in excess of 50 percent of the total gain) would be recaptured on disposition of the house.
- Full recapture of this special subsidy would occur if the dwelling were sold within 5 years; recapture would phase-out in years 6 through 10.
- A special rule would exclude from recapture part or all of the special subsidy in the case of participants whose incomes were less than prescribed amounts at the time of the disposition. The recapture provision would not apply in the case of home improvement loans.

Recapture generally would apply to financing provided and MCCs issued after December 31, 1988. Borrowers receiving loans after that date also would be exempt if loans were made pursuant to binding contracts with homebuilders, lenders, or borrowers entered into before June 23, 1988, and if the bonds were either (a) issued before that date, or (b) issued before August 1, 1988, pursuant to applications for state bond volume authority made before July 1, 1988. (see *Real Estate Outlook*, July 1988).

The Low-Income Rental Housing Tax Credit

The House bill also provides an extension of the Low-Income Rental Housing Tax Credit (LITC) which was due to expire at the end of 1989. This provision will sunset at the end of 1990 if the House version is enacted into law.

How the Program Works

A rental housing project is eligible for the tax credit if either: a) 20 or percent more of the units are occupied by individuals who have incomes of 50 percent or less of the area median income; *or* b) 40 percent or more of the units are occupied by individuals who have incomes of 60 percent of the area median income. The income standard is adjusted for family size.

The gross rent charged to the families in these units can be no greater than 30 percent of the monthly qualifying income. The incomes of the tenants are verified on an annual basis to check for compliance; however, a special provision allows individual tenants who qualified when they first occupied the unit to continue to qualify even if their income increased beyond the maximum qualifying income level.

State Credit Limits

Congress has placed annual limits on the amount of tax credits which each state may authorize. The limit is set at $1.25 per state resident for the previous year. This creates a nationwide limit of about $300 million on the program. The project will receive the credit the year it is placed into service not the year construction begins. Presumably, the project could secure a commitment of credits before the project is started. These commitments will depend upon the amount of prior commitments, the state's credit cap, and the state's authority to issue credits at the projected completion of the project.

The Credit Amount

The amount of the credit that a project receives depends upon the type of project and the type of other federal assistance received. For projects placed in service in 1987:

- Expenditures for new construction, but not acquisition costs, are eligible for a nine percent credit against total expenditures for qualifying units. Rehabilitation costs of existing housing are treated in this same manner.
- New construction and rehabilitation expenditures which are financed by subsidized federal loans or tax-exempt bonds are eligible for a four percent credit. However, community or urban development grants are not treated as a federal subsidy.
- Costs of acquiring an existing housing project, whether federally assisted or not, are eligible for a four percent credit. The project must have been placed in service more than ten years prior to the current acquisition.

Probably the most complex aspect of using this credit involves the change made for projects placed in service after December 31, 1987. The nine percent credit discussed above will be changed such that the amount of the credit each year will remain equal but the present value of the credits will equal 70 percent of the project's depreciable basis. This present value will depend upon the prevailing market interest rates. As interest rates increase, the credit percentage will increase so that the present value will always be 70 percent of the basis. Similarly the four percent credits will adjust to allow the present value of the credit over ten years to equal 30 percent of the project's depreciable basis. This provision is intended to insulate the value of the credit from any changes in interest rates.

Recapture of Credits

The credits are received over the first ten years of the housing project's service even though the project must continuously meet compliance standards for 15 years. In essence, the credit is a 15 year program "accelerated" to a ten year payout horizon. Thus if a specific project fails to comply due to excessive vacancies in low-income units or above standard income levels of individuals in these units, then the "accelerated" portion of the credits is recaptured with interest. A sale of the project can also cause a recapture of the credits unless the compliance period has been completed or a bond is posted with the Treasury by the seller to guarantee compliance for the remainder of the 15 years.

Incentives for Individual Investors

Income from these projects will be subject to the passive activity loss limitations as would income from other rental property. Two exceptions are made:

- Limited partners as well as "active participants" may use the $25,000 exception from loss limitation for these projects. This loss limit is equivalent to $7,000 in tax credits per investor.
- This exception will phase out at income between $200,000 and $250,000 instead of between $100,000 and $150,000 for most rental real estate. Unused credits may be carried forward and used to offset gain at time of sale but any unused credits beyond that amount are forfeited.

As a consequence, investors and their property managers and accountants will thus have to track many different project characteristics to determine a project's potential return. Since these items may be difficult to project for the 10 year credit period, the project itself will be difficult to value.

Future of the LITC

The difficulties discussed above plus the uncertainty over the continuation of the tax credit and other changes in the tax code have resulted in limited use of the credit. An article in the July 19, 1988 issue of the *Wall Street Journal* suggests that only 50 to 60 percent of the $300 million overall allotment of credits will be used in 1988. Some authorities quoted in the article feel that the number of program requirements is discouraging individual investors. Other experts feel that the program needs time to "catch on" in the private marketplace. They feel it should be extended beyond the December 31, 1989 sunset date to allow developers time to organize and implement these projects.

Additional Real Estate-Related Proposed Tax Changes

The House Ways and Means Committee bill also contains three minor provisions relating to real estate:

- *Capital Gains Rollover for a Surviving Spouse.* Present law provides a rollover of the capital gain on a taxpayer's principal residence if the taxpayer reinvests the sale price of the old residence in a new principal residence within two years. The Committee agreed that the rollover would be available in situations where one spouse dies after the sale of the old residence and before the date of the purchase of the new residence. The provision would apply to the sale of an old residence by the surviving spouse after December 31, 1984.
- *Special Use Valuation of Farm Property for Estate Tax Purposes.* A surviving spouse's cash rental of specially-valued real property to qualified heirs would not result in the property failing to be treated as still used in a qualified use for purposes of the special use valuation recapture tax.
- *Multifamily Rental Housing Bond Restrictions Applicable to Certain Obligations of Section 501(C)(3) Organizations.* The Committee agreed to extend the private, for-profit low-income tenant occupancy requirements to qualified residential rental property financed with qualified 501(c)(3) bonds. A property financed with governmental bonds would be treated as a non-purpose investment under the Tax Code arbitrage rules if it were located outside the jurisdiction of the governmental unit issuing the bonds. These provisions would apply to bonds issued after July 14, 1988.

Update on UBIT

The unrelated business income tax (UBIT) issue remains in legislative limbo in the Ways and Means Oversight Subcommittee and is likely to stay that way throughout this year. The June 23 staff recommendations on UBIT, which reflect subcommittee decisions made in May, are a move toward resolving problems of competition between nonprofit organizations and the small business community. However, the recommendations do not address many of the members' specific concerns and thus have not generated the support necessary to be forwarded to the full committee.

Oversight Subcommittee Chairman J.J. Pickle had hoped to send a final package to the full committee before the Fourth of July recess. He indicated in a letter that accompanied the recommendations that the subcommittee members would meet one more time during the last week of June to discuss the recommendations before voting on them. However, no meeting has been scheduled, in part because the full committee markup of technical corrections legislation took longer than expected. This delay has the advantage of keeping the UBIT issue separate from the revenue-raising discussions

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Sources: "UBIT Recommendations Likely To Remain in Limbo This Year", *Tax Notes* July 25, 1988 pp. 328-330.

"Senate Panel Approves Bill To Fix Errors in '86 Tax Law," *The Washington Post*, July 27, 1988, p. F12.

"The Low-Income Rental Housing Credit," Douglas B. Diamond, Jr., *Home Building After Tax Reform: A Builder's Guide* National Association of Home Builders, November 1986.

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	ACTUAL		FORECAST						ACTUAL		FORECAST		
	1988.1	1988.2	1988.3	1988.4	1989.1	1989.2	1989.3	1989.4	1986	1987	1988	1989	1990
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4725	4807	4894	4974	5057	5142	5213	5284	4240	4527	4850	5174	5497
% Change	5.4	7.2	7.5	6.7	6.8	6.9	5.7	5.5	5.6	6.8	7.1	6.7	6.2
% Change (w/out inflation)	3.4	3.1	3.2	2.6	2.3	2.7	1.7	1.9	2.8	3.4	4.0	2.5	2.1
Consumer Price Inflation (CPI)	3.4	4.8	4.7	5.1	5.3	5.3	4.8	4.3	1.9	3.7	4.1	5.0	4.7
GNP Inflation (GNP Deflator)	1.7	4.1	4.1	3.9	4.4	4.1	3.9	3.6	2.7	3.3	3.0	4.1	4.1
Unemployment Rate - Civilian	5.7	5.4	5.3	5.1	5.1	5.1	5.2	5.2	7.0	6.2	5.4	5.2	5.4
Civilian Employment-Household Basis (millions)	114.2	114.6	115.4	116.0	116.4	116.9	117.2	117.5	109.6	112.4	115.1	117.0	118.3
Percent change	2.6	1.5	2.7	2.2	1.3	1.5	1.1	1.1	2.3	2.6	2.3	1.7	1.1
Index of Industrial Production	134.5	136.0	137.4	138.6	138.9	139.5	139.6	140.0	125.1	129.8	136.6	139.5	141.6
Manufacturing Capacity Utilization	82.7	83.1	83.4	83.5	83.6	83.8	83.6	83.5	79.7	81.0	83.2	83.6	83.4
Domestic Auto Sales	7.6	7.5	7.4	7.3	7.3	7.2	7.1	7.1	8.2	7.1	7.4	7.2	7.1
Federal Tax Receipts (NIPA) as % of GNP	20.1	20.5	20.2	20.2	20.3	20.3	20.3	20.3	19.5	20.2	20.3	20.3	20.9
Federal Expenditures (NIPA) as % of GNP	23.4	23.0	22.9	23.0	23.1	23.0	23.0	22.9	24.4	23.7	23.1	23.0	22.9
Deficit(NIPA)	-155.1	-118.8	-133.5	-135.7	-141.5	-135.1	-139.4	-136.0	-205.6	-157.8	-135.8	-138.0	-109.0
as % of GNP	-3.3	-2.5	-2.7	-2.7	-2.8	-2.6	-2.7	-2.6	-4.9	-3.5	-2.8	-2.7	-2.0
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4314	4660	4579	4382	4205	4350	4389	4132	4712	4648	4484	4269	4214
Percent change -- year ago	-10.1	-0.8	1.1	-1.5	-2.5	-6.7	-4.2	-5.7	10.8	-1.4	-3.5	-4.8	-1.3
Existing Single-family Home Sales ($1000)	3250	3630	3550	3375	3210	3340	3410	3150	3565	3526	3451	3278	3205
Percent change -- year ago	-10.1	0.6	3.5	-0.4	-1.2	-8.0	-3.9	-6.7	10.9	-1.1	-2.1	-5.0	-2.2
Housing Starts (thousands)	1477	1474	1450	1432	1408	1439	1395	1401	1812	1634	1458	1411	1449
Percent change -- year ago	-17.0	-8.2	-10.4	-6.6	-4.6	-2.4	-3.9	-2.1	4.1	-9.8	-10.8	-3.2	2.7
Single-Family Units	1097	1062	1061	1038	1026	1042	1009	1012	1183	1157	1065	1022	1041
Percent change -- year ago	-11.9	-6.6	-8.1	-4.7	-6.4	-1.9	-4.9	-2.5	10.4	-2.2	-8.0	-4.0	1.8
Multi-Family Units	380	412	390	394	382	398	385	389	630	477	394	389	408
2-4 Family Units	56	60	56	57	55	58	56	56	85	66	57	56	59
Percent change -- year ago	-29.0	-17.1	2.0	1.2	-1.7	-3.4	-1.1	-1.2	-9.0	-22.6	-12.7	-1.9	5.1
5+ Family Units	324	352	333	337	327	340	330	333	545	412	336	332	349
Percent change -- year ago	-28.7	-11.2	-18.6	-13.0	1.0	-3.4	-1.1	-1.2	-5.6	-24.4	-18.3	-1.2	5.1
New Single-family Home Sales (thousands)	630	697	657	610	590	630	615	570	750	671	649	601	550
Percent change -- year ago	-12.9	3.4	-2.7	-1.8	-6.3	-9.6	-6.4	-6.6	9.0	-10.5	-3.4	-7.3	-8.5
Mobile Homes Shipped (thousands)	207	215	212	213	206	210	206	207	246	233	212	207	216
HOME PRICES													
Existing Home Prices - Median $(1000)	87.8	88.9	91.2	91.6	92.2	94.3	94.9	95.6	80.3	85.6	89.9	94.3	99.3
Percent change -- year ago	4.2	4.5	6.7	7.8	5.0	6.1	4.1	4.4	6.4	6.6	5.0	4.9	5.4
New Home Prices - Median $(1000)	112.9	112.9	114.5	115.5	117.0	121.0	122.5	123.7	92.0	104.0	114.0	121.1	126.0
Percent change -- year ago	16.0	9.1	7.8	3.3	3.6	7.1	7.0	7.1	9.1	12.9	9.6	6.2	4.1
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year FRM (FHA Secondary)	10.1	10.7	10.8	11.1	11.3	11.4	11.4	11.4	9.9	10.2	10.7	11.4	11.2
1-year ARM (without buydown)	7.5	7.6	7.6	7.8	8.1	8.2	8.2	8.3	7.9	8.2	7.6	8.2	8.0
30-year Corporate AAA Bond Rate	9.6	9.8	10.2	10.5	10.6	10.8	10.8	10.9	9.0	9.4	10.0	10.8	10.5
30-year Government Bond Rate	8.6	9.1	9.5	9.7	9.9	10.0	10.1	10.1	7.8	8.6	9.2	10.0	9.7
Short-Term Interest Rates													
Federal Funds Rate	6.7	7.2	7.6	7.7	7.9	8.0	8.0	8.0	6.8	6.7	7.3	8.0	7.8
3-month T-Bill Rate	5.7	6.2	6.8	6.9	7.0	7.1	7.2	7.2	6.0	5.8	6.4	7.1	6.7
Prime Rate	8.6	8.8	9.3	9.4	9.5	9.7	9.8	9.8	8.3	8.2	9.0	9.7	9.6
Discount Rate	6.0	6.0	6.0	6.0	6.2	6.3	6.5	6.5	6.3	5.7	6.0	6.5	6.4
Value of the U.S. Dollar (Trade-Weighted Avg.)	90.0	90.4	95.6	93.2	90.0	87.1	85.2	84.0	112.3	96.9	92.3	86.6	82.8
Percent change	-9.4	1.7	24.9	-9.8	-12.8	-12.2	-8.8	-5.1	-21.6	-13.6	-4.8	-6.2	-4.4

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick, Sean Burns and Beth Maerz.

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